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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 378

THE FIRST NATIONAL BANK, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 2a-7a)[1] are reported at 22 T.C. 209. The *per curiam* opinion of the Court of Appeals (Pet. 15) is reported at 221 F. 2d 959.

JURISDICTION

The judgment of the Court of Appeals was entered on May 11, 1955. A petition for rehearing

[1] Record references are to the Appendix to the taxpayer's brief in the Court of Appeals. Supplemental record references are to Appendix B to the Commissioner's brief in the Court of Appeals.

was denied on June 7, 1955. (Pet. 16.) The time for filing a petition for a writ of certiorari was extended to and including September 15, 1955, by order of Mr. Justice Burton dated September 6, 1955. The petition for a writ of certiorari was filed on September 8, 1955. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

This case deals with the right of a taxpayer to exclude from income a portion of its recovery of bad debts, pursuant to Section 22(b)12 of the Internal Revenue Code of 1939 permitting the exclusion from income of the recovery of bad debts previously charged off to the extent the prior deduction did not result in a reduction in tax. Specifically, the question is whether the determination of the taxpayer's benefit from the bad debt deduction is to be based on the taxpayer's return for the earlier year or whether additional deductions and exclusions may now be used to change the extent of the tax reduction resulting from the bad debt deduction.

STATUTE INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 are:

SEC. 22. GROSS INCOME.

* * * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross

income and shall be exempt from taxation under this chapter:

* * * * *

(12) [As added by Section 116(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) *Definition of Bad Debt.*—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

* * * * *

(D) *Definition of Recovery Exclusion.*—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduc-

tion of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

(26 U.S.C. 1952 ed. 22.)

* * * * *

STATEMENT

The material facts, as stipulated and found by the Tax Court (R. 2a-4a, 9a-12a), may be summarized as follows:

The taxpayer reported a net loss of $6,023.35 on its corporation income and excess profits tax return for 1937. The Commissioner made no changes in the income, deductions, or tax for that year. Shown as deductions on that return were bad debts aggregating $58,933.17. (R. 2a, 9a-11a.) The tax benefit allowed the taxpayer upon the charge-off of the bad debts therefore amounted to $52,-909.82 ($58,933.17 minus $6,023.35). (R. 11a.)

If the taxable income of the taxpayer for 1937 were now recomputed to take into account allowable items of exclusion and deduction not taken on its 1937 return, the resulting net loss would be $19,254.74 (R. 3a-4a, 11a), and the tax benefit would be $39,678.43.

During the years 1938 to 1948, inclusive, the taxpayer recovered a total of $18,566.01 on the $58,-

933.17 bad debt deductions that it claimed and was allowed for 1937. In 1949, the taxpayer recovered an additional $2,018.22. (R. 2a, 12a.)

Had the taxpayer filed a return for 1937 which took into account all the allowable deductions and exclusions, the amount of bad debts charged off in 1937 which could be recovered in 1949 and not be included in taxable income under Section 22(b)(12) of the Code would be $688.73 ($19,254.74 minus $18,566.01). (R. 2a, 4a, 12a.)

The Tax Court held that the taxpayer was not entitled to exclude this $688.73. (R. 6a, 7a.)[2] The Court of Appeals affirmed on the opinion of the Tax Court. (Pet. 15.)

ARGUMENT

Section 22(b)(12) of the 1939 Internal Revenue Code, *supra*, p. 3, which was added by Section 116(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, provides for the exclusion from gross income of amounts attributable to the recovery during the taxable year of bad debts, to the extent that the deduction of such debts did not operate to reduce the income tax liability of the taxpayer for any prior taxable year, reduced by the amount excludible in previous taxable years with respect to such debt. See H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 69-70 (1942-2 Cum. Bull. 372, 426-427); S. Rep. No. 1631, 77th Cong., 2d Sess.,

[2] This case was reviewed by the full Tax Court; no dissents were noted.

pp. 79-80 (1942-2 Cum. Bull. 504, 565-566); Treasury Regulations 111, Sec. 29.22(b)(12)-1.

Section 22(b)(12) is a relief measure for the benefit of taxpayers who bring themselves within its terms. *Dobson* v. *Commissioner,* 320 U.S. 489, 505. The only question here presented is whether this taxpayer has brought itself within the terms of the statute. Cf. *United States* v. *Olympic Radio & Television,* 349 U.S. 232, 235. We submit that it has not, and both courts below so held.

It is acknowledged (R. 4a) that taxpayer could exclude from its taxable income in subsequent years recoveries on bad debts charged off in 1937 until the recoveries equaled $6,023.35, the net loss shown on its return as filed and accepted for that year; but the courts below rejected (R. 6a) the taxpayer's contention that, notwithstanding the running of the statute of limitations, the year 1937 should be reopened for the purpose of showing that taxpayer had other allowable exclusions and deductions which it might have taken, but did not in fact take, which would increase its net loss to some $19,000 and thus produce a recovery exclusion of $688.73 for 1949.

That contention is without support in the statute, the regulations or the committee reports. There is nothing in any of these to indicate that Congress in passing Section 22(b)(12) intended to lift the bar of the statute of limitations in order to re-determine whether a given deduction for an earlier year produced a tax benefit.

On the contrary, the statutory language indicates that the computation is to be based upon the facts as shown on the return filed for the original year or as made part of the final computation for that year. In this connection the Tax Court aptly said (R. 4a-5a):

> There is not a great deal to indicate what Congress might have intended in a case like this but such indications as appear support the Commissioner. Certainly no change could be made in the bad debt deduction for 1937 because the statute refers to only those bad debts for "which a deduction * * * was allowed for a prior taxable year." It is difficult to believe that Congress meant to allow other deductions or exclusions not shown on the 1937 return when it limited the bad debt, prior tax, and the delinquency amount on which recoveries could be made to the amounts "allowed for a prior taxable year." Section 22(b)(12)(D) defines the "recovery exclusion" as the amount of the deductions allowed for bad debts "which *did not result* in a reduction of the taxpayer's tax under this chapter." [Emphasis supplied.] Likewise, in the legislative history of the provision, the expression "did not in any prior taxable year reduce his income tax liability," or its equivalent, appears several times. These phrases using the words "did not," as contrasted with "would not have" or "could not have" indi-

> cate that Congress meant to accept the final results of the prior years and did not intend that changes, even corrections, could be made after those results had become final. Corrections, if permissible, could work advantages for the Commissioner as well as for the taxpayer and might apply also to the intervening years during which recoveries were made on the bad debts charged off.

And see *Mathey* v. *Commissioner,* 177 F. 2d 259, 264 (C.A. 1), certiorari denied, 339 U.S. 943.

It would require plain statutory authorization, here lacking, to conclude that the bar of the statute of limitations should be lifted in this case, and it makes no difference that in some instances it might be to the advantage of the Commissioner and not the taxpayer to reopen an earlier year.[3] *Rothensies* v. *Electric Battery Co.,* 329 U.S. 296. In that case this Court said (pp. 301, 302):

> It probably would be all but intolerable, at least Congress has regarded it as ill-advised,

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[3] It would, for example, be to the Commissioner's advantage in this case to reopen the year 1941. In computing the gain or loss it realized on the sale of Denver & Rio Grande and Chicago & Great Western bonds during 1941, the taxpayer used as its basis the cost of the bonds. It is agreed that the taxpayer should have used as its basis the cost of the bonds less the amounts it was allowed as bad debt deductions in 1937 due to their having become partially worthless during that year. The taxpayer realized a tax benefit of $29,596.92, through its error. (Supp. R. 25-27.) Unfortunately from the Commissioner's standpoint, the year 1941, like the year 1937, is closed by the statute of limitations.

> to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. Hence, a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy.
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> * * * * *
>
> As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out. They tempt the equity-minded judge to seek for ways of relief in individual cases.

The taxpayer relies (Pet. 7) on *Lewis* v. *Reynolds,* 284 U.S. 281; *Bull* v. *United States,* 295 U.S. 247; *Commissioner* v. *Van Bergh,* 209 F. 2d 23 (C.A. 2), but we submit that such reliance is misplaced. In *Lewis* v. *Reynolds,* this Court held that in acting upon a claim for refund based upon the disallowance of a particular deduction, the Commissioner has authority to reaudit the return and to reject the claim on the basis of the disallowance of another deduction even though the statute of limitations prevents him from making an

additional assessment for the year involved. In *Bull* v. *United States,* in a suit by the Government for income tax, the Court held that the taxpayer, by way of recoupment, could successfully assert an overpayment of estate tax, arising from the same transaction, although the statute of limitations would have precluded an independent suit by taxpayer for the refund of the estate tax. In *Commissioner* v. *Van Bergh,* the Second Circuit, applying these decisions in a situation where the taxpayer was admittedly entitled to carry back a net loss to an earlier year under Section 122 of the 1939 Code, held that nevertheless taxpayer was not entitled to a refund for the earlier year if he had in fact underpaid his tax for that year and in this connection the Commissioner was free to rely upon new grounds even if the statute of limitations barred assessment. In the first two of these cases, this Court went behind the statute of limitations only where one taxable year was involved (*Lewis* v. *Reynolds, supra*) or where there was a single taxable event (*Bull* v. *United States, supra*). Recognizing this, the Second Circuit in the *Van Bergh* case took the view that under the provisions of Section 122 relating to carry-backs and carry-overs to certain preceding and succeeding taxable years, Congress intended to treat the loss as a deduction from income in the earlier, or the later, year; and that being so it followed that in determining the right to a refund based upon a carry-

back, the year to which the carry-back was taken could be reopened notwithstanding the statute of limitations.

In the instant case, the *Van Beigh* case was called to the attention of the court below, and it evidently thought its decision there could stand with the one here. We think so, too, for it is clear that there is a real difference between carrying back a net loss under Section 122 and determining the right to a recovery exclusion under Section 22(b)(12). Decision under 22(b)(12) depends upon whether taxpayer derived any tax benefit from deducting the bad debt in the earlier year, but the recovery exclusion for the later year is not an exclusion for the earlier year when the debt was charged off; and there are two separate and distinct events: (1) the debts becoming worthless in the earlier year; (2) the recovery in the taxable year.

The taxpayer criticizes (Pet. 8-10) the Tax Court's conclusion that the statutory language precludes reopening the earlier year. In this connection the taxpayer says that the reason the statute refers to bad debts "allowed" as a deduction in an earlier year is to make it clear that those allowable but not in fact claimed as a deduction cannot constitute the basis for a recovery exclusion.[4] But even if that were so, it would not de-

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[4] Incidentally, the Commissioner appears to have taken the position under pre-1942 law that a recovery on a bad debt

tract from the significance of the word "allowed" which indicates that in determining the question as to tax benefit no consideration should be given to exclusions and credits that were not allowed. Taxpayer also says that the statutory use of the words "did not result in a reduction of the taxpayer's tax" in defining a recovery exclusion does not indicate that Congress was concerned only with the actual tax for the earlier year as contrasted with what it might have been if additional deductions and exclusions had been taken. But taxpayer's argument adds nothing to the natural meaning of the words used. We think it plain from a fair reading of the statute that Congress did not intend to permit the reopening of the earlier year.

Taxpayer's assertion (Pet. 11) that Congress specifically made an exception to the statute of limitations by enacting Section 22(b)(12) is without foundation; and taxpayer's position is contrary to this Court's ruling in *Rothensies* v. *Electric Battery Co., supra.* And see *United States* v. *Garbutt Oil Co.,* 302 U.S. 528, 533-535; *Pacific National Co.* v. *Welch,* 304 U.S. 191, 194.

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previously charged off and *allowed* as a deduction, must be included in gross income for the year in which received. See *Helvering* v. *State-Planters Bank & Trust Co.,* 130 F. 2d 44, 45-46 (C.A. 4th); Treasury Regulations 103, Section 19.23 (k)-1.

CONCLUSION

The decision below is correct and there is no conflict of decisions requiring review. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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